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November 15, 2004

**AGENDA ITEM: 6d**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Corporate Governance – Executive Compensation Strategic Plan
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Adopt CalPERS' three-year strategic plan for executive compensation reform inclusive of six specific (three Macro Economic and three Micro Economic) strategy recommendations.
- IV. ANALYSIS:**

**Executive Summary**

Compensation programs are one of the most powerful tools available to align the interests of executive managers with those of shareowners. Since shareowners have a strong interest in long-term performance, CalPERS believes shareowners should provide stronger oversight in executive compensation programs. In recognition of this, CalPERS is recommending a three-year strategic plan (2005 – 2007) for executive compensation reform in order to raise the level of accountability of boards and compensation committees to shareowners.

In this agenda item, Staff recommends adopting CalPERS' strategic plan for executive compensation reform supported by a proposed Mission, Objective and 6 specific Strategies. Staff outlines three macro economic strategies designed to advocate national reform which include: 1) SEC engagement; 2) SRO/Exchange engagement; and 3) Compensation Consulting Industry engagement. In addition, Staff outlines three micro economic strategies designed to address reform on a company by company basis which include: 1) Engaging the largest companies to promote compensation reform; 2) Enhancing compensation committee accountability; and 3) Recognizing pay-for-performance leaders.

## **Background**

In June 2003, CalPERS adopted policy positions related to executive compensation. The policy positions address proxy voting in relation to equity compensation plans, provide a model executive compensation policy framework (for corporations to utilize) and propose an executive compensation analytical model. Staff continues to implement the June 2003 Executive Compensation Program through existing programs such as the Focus List and proxy voting function.

At the July 2004 offsite board meeting, the Committee expressed a strong interest in continuing to emphasize reform in executive compensation as part of CalPERS' Corporate Governance Program. Attachment 1 contains a copy of a follow-up letter signed by Controller Westly urging CalPERS to raise the bar on executive compensation by taking a leadership position in coordinating broad investor support and in developing a focused corporate governance strategy to achieve national executive compensation reform.

Attachment 2 contains a copy of a letter from Treasurer Angelides, Sean Harrigan, Chuck Valdes, Rob Feckner, Priya Mathur and George Diehr requesting the Committee to adopt new policies regarding severance packages, to enlist the support of other institutional shareholders on this issue and further consider a visible campaign in 2005 on an identified set of executive compensation and merger plans.

Implicit in the strategic plan staff is presenting to the Committee is the belief that the philosophy and practice of executive compensation in the U.S. needs to be more performance-based. Staff believes that the most successful strategy in addressing excessive executive compensation will be to hold management accountable for company performance and to focus on performance-based pay.

Staff is proposing the following mission, objective and six specific strategies as CalPERS' strategic plan for its executive compensation program:

## **Mission**

**CalPERS' mission is to achieve comprehensive reform of executive compensation practices by advocating, influencing, and educating companies to properly align the interests of boards and management with those of shareowners.**

The following four policy guidelines set forth in CalPERS' model executive compensation policy framework will form the basis of CalPERS' comprehensive executive compensation strategic plan:

- 1) Executive compensation programs should be designed and implemented to ensure alignment of interest with the long-term interest of shareowners.
- 2) Executive compensation should be comprised of a combination of cash and equity-based compensation. Direct ownership should be encouraged.
- 3) Executive compensation policies should be transparent to shareowners. The policies should contain, at a minimum, compensation philosophy, the targeted mix of base compensation and “at risk” compensation, key methodologies for alignment of interest, and parameters for guidance of employment contract provisions, including severance packages. These policies should be submitted to shareowners for approval on a periodic basis.
- 4) Executive contracts should be fully disclosed, with adequate information to judge the “drivers” of incentive components of compensation packages.

### **Specific Objective**

**Support CalPERS’ mission by advocating national reform, raising the level of accountability of boards and compensation committees at CalPERS portfolio companies, and building a broader coalition of national support for CalPERS’ effort to align executive compensation practices with shareowner interests.**

### **Specific Strategies**

In this agenda item, Staff outlines three macro economic strategies designed to advocate national reform in executive compensation. In addition, Staff outlines three micro economic strategies designed to address executive compensation reform on a company by company basis.

#### **Macro Economic Level Strategies: To Advocate National Reform**

##### **1) SEC Engagement:**

Enhanced transparency of executive compensation supports CalPERS’ mission to advocate economic alignment of boards and management with shareowners. The SEC has recently made several comments indicating a strong desire to ensure that publicly traded companies provide investors with greater transparency of compensation packages. Current reports that the SEC is studying executive compensation disclosure rules provide an immediate opportunity for CalPERS to advocate enhanced transparency in corporate disclosure.

Therefore, Staff believes engaging the SEC in order to advocate national executive compensation reform through enhanced transparency in corporate

disclosure should be accomplished in the first year of CalPERS' three year strategic plan.

Recommendation - Staff recommends CalPERS:

- Develop and submit to the SEC a comprehensive proposal for increased disclosure related to executive compensation in 2005.
- Coordinate broad institutional investor collaboration to support SEC rule making for increased disclosure related to executive compensation.

## 2) SRO/Exchange Engagement:

Self Regulatory Organizations ("SROs") do not have a direct role in establishing the compensation policies at listing companies. Nor do the stock exchanges make the final determination related to disclosure issues or compensation committee structure that can be so important in the area of executive compensation. However, they still play a critical role in reform due to their central function in the financial markets and in establishing listing standards.

Examples of items that may be of mutual interest to investors and the SROs include the role and structure of compensation committees, approval of and/or greater clarity in executive compensation policies at listing companies, and increased communication between listing companies and the investment community related to executive compensation.

Staff believes engaging the SROs/Exchanges in order to advocate national executive compensation reform will be a longer-term process encompassing all three years of CalPERS' strategic plan. Staff would expect to open a dialog with the leadership of the exchanges in 2005 in order to communicate CalPERS' strategic plan for executive compensation reform. By the end of 2007, staff would expect to have achieved enhancements to listing standards that incorporate compensation philosophy and practice to better align boards and management of listed companies with shareowners.

Recommendation - Staff recommends CalPERS:

- Engage national SROs/Exchanges to seek support in the development of executive compensation disclosure requirements.
- Advocate the enhancement of exchange listing standards that incorporate compensation philosophy and practice to better align boards and management of listed companies with shareowners.

## 3) Compensation Consulting Industry Engagement:

The compensation consulting industry is widely viewed as part of the problem in executive compensation being minimally connected to performance metrics in compensation plans today. Compensation consultants communicate with CalPERS' portfolio companies on a yearly basis. Therefore, CalPERS should

proactively communicate the Fund's preferred compensation philosophies, policies and practices to the compensation consultants in an effort to reform the construction of compensation packages to better align boards and management with shareowners. Providing the relatively concentrated compensation consulting industry with a better understanding of investors' preferences related to compensation programs could be highly effective.

Staff believes engaging the compensation consulting Industry in order to advocate national executive compensation reform will be a longer-term process encompassing all three years of CalPERS' strategic plan. In 2005, staff would collaborate with other institutional investors in the U.S. to develop a focused approach of engaging the compensation consulting industry to address compensation reform. In this effort, staff will determine those CalPERS policy positions and proxy voting guidelines which overlap with the beliefs of other institutional investors and attempt to affect change by having a number of large investors meet with the major compensation consulting firms. Staff would expect CalPERS portfolio companies that utilize a compensation consultant in 2005 and 2006 to implement greater pay for performance metrics in compensation plans that come to shareowner vote in 2007.

Recommendation - Staff recommends CalPERS:

- Take a leadership position in coordinating institutional investor support to develop a focused approach of engaging and communicating investors' compensation program preferences to the compensation consulting industry.
- Educate the compensation consulting industry with a better understanding of shareowner's preferences for how companies utilize executive compensation to better align boards and management with shareowners.
- Affect compensation consulting practices to address executive compensation reform by engaging the major compensation consulting firms.

### **Micro Economic Level: To Advocate Company-by-Company Reform**

#### **1) Engaging the largest companies to promote executive compensation reform.**

This strategy would focus on executive compensation reform of a defined number of CalPERS' top holdings (determined by industry sector and market capitalization). The topic of executive compensation inevitably lends itself to peer group evaluations where companies within a given industry benchmark their practices and policies to companies of a similar size and market characteristics. As a result, staff believes significant progress could be made by addressing the largest companies in each industry or market segment. Staff believes that if appropriate performance-based metrics are employed at the largest, industry-leading companies these standards will flow down to the smaller capitalized companies.

Staff would expect to engage the largest companies to promote executive compensation reform in each of the three years defined by CalPERS' strategic plan. Upon approval of CalPERS' strategic plan for addressing executive compensation, staff would identify the largest companies within each of the major sector classifications. Staff has identified 10 major sector classifications<sup>1</sup>. Companies within each sector most in need of executive compensation policy reform would be targeted.

At a minimum, staff would expect to engage the largest companies with abusive executive compensation practices in CalPERS' index portfolio to seek improvements in those practices and compensation policies for the next several years. Upon completion of CalPERS' three year strategic plan, staff expects to have been instrumental in moving executive compensation philosophy and practice toward greater pay for performance concepts at a number of the largest CalPERS portfolio companies.

Recommendation - Staff recommends CalPERS:

- Engage the largest companies with abusive compensation practices within each of the major sector classifications utilizing a combination of our own internal expertise and external institutional investor support.
- Advocate CalPERS' Executive Compensation Mission and model policy guidelines to better align boards and management of CalPERS' portfolio companies with shareowners.
- Coordinate institutional investor support beginning in 2005 to wage a visible and effective shareowner campaign against the largest companies that refuse to implement CalPERS' executive compensation model guidelines to better align boards and management with shareowners.

## 2) Enhancing Compensation Committee Accountability:

This micro economic strategy would focus on directors sitting on compensation committees that can be reasonably linked to approving poor executive compensation packages and policies. The compensation committee has the ultimate authority for the design of executive compensation plans and policies for approval of individual awards. A clear focal point of executive compensation reform should be the compensation committee and the performance of the individual directors who sit on the committee.

Staff believes engaging compensation committees to enhance accountability to shareowners through executive compensation will be a longer-term process encompassing all three years of CalPERS' strategic plan. Opportunities to engage and withhold support for compensation committee members would be expected in all three years. Beginning immediately in 2005, staff will assess

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<sup>1</sup> The 10 major sector classifications are: Energy, Materials, Industrials, Consumer Discretionary, Consumer Staples, Health Care, Financials, Information Technology, Telecommunication Services, and Utilities.

compensation committee and individual director performance by evaluating the following criteria at a minimum:

- Compensation committee members who sit on multiple boards that exhibit a weak link between executive compensation and economic performance.
- Egregious use of severance packages related to mergers, acquisitions and spin-offs including at a minimum: 1) The use of accelerated vesting of options for top executives in mergers; 2) Inappropriate links between severance/change-of-control payments and post-merger economic performance; 3) Recapitalizations where the management and shareowner base does not substantially change but egregious change-in-control payments are triggered; and 4) The inclusion of "gross-ups" to pay the federal taxes owed on excessive golden parachute awards.
- High percentages of negative votes for equity plan approval within recent years. Low levels of support related to approval of an equity plan may be an indication of investor concern over the compensation practices.
- Companies with the greatest levels of total equity dilution and the highest run rates (equity granted per year divided by total shares outstanding).
- Companies that use broad based plans with grant patterns that indicate excessive distribution of equity grants to the top five executives.
- Compensation committees with the greatest percentage of sitting and retired CEOs to determine if there is a correlation with poor pay-for-performance characteristics.

Upon identification of compensation committee members who approve poor executive compensation practices, staff would use a targeted approach to engage, or withhold support via the proxy in the most egregious cases, those directors in order to seek improvements in their executive compensation programs. In order to support greater focus on compensation committee members that approve poor executive compensation packages and policies, staff would use internal resources, such as CalPERS' pay-for-performance model and qualitative review, and seek input from other investors and various experts within the investment community.

Recommendation - Staff recommends CalPERS:

- Raise the level of accountability of targeted boards and compensation committees at CalPERS portfolio companies in order to move executive compensation philosophy and practice in the U.S. toward the concept of pay for performance.
- Publicly withhold support from selected directors on compensation committees at portfolio companies where shareowner value has been eroded as a result of egregious compensation packages.
- Join other institutional investors beginning in 2005 to wage a visible and effective shareowner campaign against an identified set of egregious executive compensation practices that do not meet CalPERS' model guidelines.

3) Recognizing pay for performance leaders:

Staff believes that CalPERS' objectives in executive compensation are best achieved using a multi-faceted approach that includes recognition for superior pay for performance practices or significant improvement toward these goals.

Recommendation - Staff recommends CalPERS:

- Compile examples of superior pay for performance practices and significant improvements in compensation plans.
- Report back to the Investment Committee by June of 2005 on the progress of this micro strategy and present a plan for recognizing the companies and individuals identified.

**Implementation of Strategic Plan to address executive compensation:**

Staff believes that CalPERS' objectives in executive compensation are best implemented using a comprehensive approach at both macro and micro levels.

Staff also expects to update CalPERS' proxy voting guidelines as applied to executive compensation and utilize shareowner proposals to facilitate advocacy efforts at portfolio companies. Therefore, staff will recommend for approval by the CalPERS Investment Committee at the December 13, 2004 Committee meeting enhanced proxy voting guidelines specific to executive compensation practices at portfolio companies and a comprehensive shareholder proposal strategy.

In an effort to wage a visible and effective shareowner campaign, staff will identify opportunities to coordinate CalPERS' focus on executive compensation with like-minded institutional shareowners such as CalSTRS, national organizations such as the Council of Institutional Investors and other national coalitions. In addition, staff will continue to monitor and stay abreast of other institutional investor initiatives, academic research and public rankings that focus on executive compensation practices, policies and models.

Recommendation - Staff recommends CalPERS:

- Implement CalPERS' strategic plan for addressing executive compensation reform over a three-year time frame beginning immediately upon approval by the CalPERS Investment Committee and ending in December of 2007.
- Provide progress reports on staff's efforts to implement CalPERS' strategic plan for executive compensation reform to the CalPERS Investment Committee in June and December of each year through 2007.



**V. STRATEGIC PLAN:**

This item is not a product of either the 2004-2005 Strategic or Annual Plan.

**VI. RESULTS/COSTS:**

Additional resources will be needed for the Executive Compensation Program but are expected to produce reform in the use of compensation at public corporations and better align the interests of management and owners. As one of the largest owners of domestic and international equities, CalPERS should benefit from a better alignment of owners and management.

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